PENSION FUND COMMITTEE

Minutes of Meeting

February 21, 2013

The Sussex County Pension Fund Committee met on February 21, 2013, at 11:00 a.m. in the County Council Chambers, Georgetown, Delaware. Those in attendance included members: Susan Webb, Todd Lawson, Karen Brewington, Jeffrey James, David Baker and Hugh Leahy. Also in attendance were Gina Jennings, Finance Director Appointee; Michael Shone of Peirce Park Group, the County's Pension Investment Consultant; and John Lessl of Aon, the County's Actuary. Committee member Lynda Messick was unable to attend.

On February 14, 2013, the Agenda for today's meeting was posted in the County's locked bulletin board located in the lobby of the County Administrative Office Building; the agenda was posted on the County's website as well.

Ms. Webb called the meeting to order and reviewed the agenda.

1. **Approval of Minutes**

A Motion was made by Mr. Lawson, seconded by Mr. Leahy, to approve the minutes of the November 7, 2012 meeting, as distributed.

Motion Adopted:	5 Yea.
Vote by Roll Call:	Mr. James, Yea; Mr. Lawson, Yea; Mr. Leahy, Yea; Mr. Baker, Yea; Ms. Webb, Yea

Ms. Brewington was not present at the time of the above vote.

2. **Investment Analysis for the Quarter Ended December 31, 2012**

Mr. Shone distributed copies of a booklet entitled, "Sussex County Investment Performance Report, December 31, 2012". The report includes information regarding the market environment for the fourth quarter of 2012,

as well as quarterly and annual performances of the Pension and OPEB Plans. Although the report should be referenced for a more detailed analysis, discussion highlights include:

Mr. Shone referred members to Market Environment – 4th Quarter of 2012 (Tab 1). He reported that equity markets ended the year on a strong note. U. S. stocks outperformed international stocks for the first half of 2012, with international stocks outperforming domestics for the second half. Fixed income returns were very small for the fourth quarter, although better than anticipated.

While U. S. markets were marginally positive for the fourth quarter of 2012, international and emerging markets were up 6.6 percent and 5.6 percent respectively. Equity markets finished strong for the year and outperformed the actuarial assumed rate of return. For the first half of 2012, growth stocks performed better than value stocks, with value stocks outperforming growth for the second half. Mid-cap value equities outperformed small and large caps for the quarter and year. Value stocks typically perform better in down markets and perform as well as growth stocks in up markets. For the year, value stocks outperformed growth.

Longer term bond yields increased during the quarter, and returns on fixed income were either flat or slightly negative. This trend for fixed income continues for the current quarter. At the time an actuary sets the assumed rate of return, they typically look at the asset allocation mix and the long-term expected rates of return for the asset classes (equities & fixed income). If yields remain consistently low, a change to the portfolio mix and/or a change in the assumption (or a combination of both) are possible options.

When asked, Mr. Shone stated investors do seem willing to sacrifice some safety in the hopes to realize increased returns with high yield bonds. He noted concern that in wanting to realize high returns, investors sometimes 'chase the yield'; high yield bonds were down approximately 20 percent in 2008. On the equity side, higher dividend stocks realized better returns in 2012, with higher yielding – more dividend oriented stocks – also performing well.

Mr. Shone directed members to the Pension Fund Performance Report (Tab II). The Pension Fund realized investment returns for the fourth quarter of 2012 of $237,000, a return of .73 percent (gross) and .66 percent (net – of all management fees). For 2012, a gain of $3.8 million was realized, or a return of 10 percent (gross) and 9.7 percent (net). The County's 9.7 percent return was one of the lower returns of Peirce Park's clients, but was expected due

to the County's conservative investment approach. Wilmington Trust had very strong returns for the fourth quarter of 2012 versus their benchmark, but lagged most managers due to the constraints placed on them by the County. Fidelity had strong returns, with DuPont Capital realizing average returns relative to their benchmark. The State of Delaware performed below their benchmark for the fourth quarter and year, although they have outperformed for the past three years. Mr. Shone explained that no fund or manager would outperform every year, particularly noting the State is more aggressive in their allocation mix (private equity and hedge funds). In the future, he suggested that the County look at their fixed income guidelines, actuarial assumptions, the L.D.I. (liability driven investing), and GASB 67 and 68 (financial reporting changes made by the Governmental Accounting Standards Board for defined benefit pension plans).

Ms. Webb questioned Mr. Shone regarding a newspaper article forwarded to him noting that the State of Delaware had overstated their funding status; the State of Delaware comprises 33 percent of the County's portfolio. Mr. Shone noted two issues: the funded status of the State plan and the investment pool, i.e. does the State change their investment pool because of their funding status. In determining the investment level needed to meet future obligations, the discount rate – or rate of return assumption – must be considered. Guidelines set by the accounting industry and credit rating agencies must also be considered. The newspaper article noted that current bond yields must be used. Mr. Shone stated that he would not use the treasury rate of return of 2 percent. He reported that it is important to know the liabilities and is the basis for the accounting industry setting some fairly rigorous guidelines.

Mr. Shone reported that a correction was made to Piece Park's third quarter report due to a valuation error – of approximately $120,000 – reported by the State.

As of December 31, 2012, the market value of the Pension Fund was $58,813,167, or a time weighted return of 10 percent. The County's investment fees are higher than most of Peirce Park's clients of similar size. The State's rate of return typically offsets their higher expense ratio and is due to their investments in private equities, hedge funds, and a slightly higher allocation in international stocks. The County's blended investment management fee is .60 percent, whereas Peirce Park's typical client is .40 percent. Based upon the State's use of alternatives and Fidelity's performance, Mr. Shone does not find their fees unreasonable.
Mr. Leahy questioned if there were other options available to the County that would realize similar results to the Delaware Investment Pool without

the use of alternatives. Mr. Shone stated that the State does allow a broader diversification than the County would typically invest. A plan of similar size – with 60 percent equities – was up approximately 11.5 percent in 2012, without the use of alternatives. Mr. Shone offered that over time the County may want to consider lessening the State portion from 60 percent to 50 to help lower the County's expense ratio.

The County's current policy index is comprised of 60 percent stocks and 40 percent bonds (14 percent international stocks, 46 percent domestic stocks, and 40 percent fixed income). When the stock market was down, the County outperformed their policy index.

Mr. Shone would not recommend any manager changes and specifically noted Wilmington Trust's 'very very good performance'. The Committee had requested Mr. Shone to speak to Wilmington Trust regarding the possibility of relaxing fixed income guidelines. He referred members to a separate 4-page handout and graph showing the "Historical Composition of the Barclays Capital U. S. Intermediate Government/Credit Index, December 31, 1994 – February 15, 2013", which reflected the specific index composition for treasuries, government-related bonds (Ginnie Maes and Fannie Maes), and corporate bonds. On average, corporate bond debt has averaged 30 percent since 1994. Mr. Shone discussed the impact of increasing government bonds. Of the 5-year spans reported, there was only one time period – 1977 to 1982 – that was not beneficial to allow more in corporates.

The current guideline for the intermediate government index is 3.6 percent for the duration of the portfolio, and would allow Wilmington Trust to go down to 2.7 and up to 4.5. Mr. Shone discussed the various options open to the County.

Mr. Shone referred members to two separate handouts, "Sussex Pension Proposed Changes" and "Sussex OPEB Proposed Changes".

Discussion was held on the below proposed changes for the Pension Fund:

1. **Investment Policy Statement:**

   To be determined

2. **Wilmington Trust Investment Management Agreement, Appendix B:**

   - **Remove first bullet**, which reads:
     Maximum exposure to the corporate sector of 25%.

Corporate bonds must have minimum rating of A3/A – at the time of purchase.
No corporate bonds may be purchased below the rating above.

- **Second bullet**:
  - **Current**: Minimum of 75% of the portfolio must be invested in direct obligations of the U.S. Treasury.
  - **New**: Minimum of 40% of the portfolio must be invested in U.S. Government securities (Treasuries and Agencies).

    (Note: As a result of discussion, the above rate of 40% is now proposed to be 50%)

- **Benchmark**
  - **Current**: Barclay's Intermediate Government Index
  - **New**: Barclays's Intermediate Government/**Credit** Index

    (Note: As a result of discussion, suggested additional language includes "duration can be no greater than 25 percent of the benchmark and no less than 50 percent of the benchmark". Current language states '25% of the benchmark'.

Mr. Leahy expressed concern that by removing the first bullet, it would allow Wilmington Trust to invest in corporate bonds of any rating, and noted the need to keep the minimum rating of A3/A.

A Motion was made by Mr. Baker, seconded by Mr. James, that the Pension Committee recommends to amend the Wilmington Trust Investment Management Agreement to reflect a minimum of 50 percent of the portfolio must be invested in U. S. Governments, Securities, Treasuries, and Agencies; Corporate Bonds must have a minimum rating of A3/A at the time of purchase; no Corporate Bonds may be purchased below the A3/A rating; the average duration will be no greater than 25 percent of the benchmark and no less than 50 percent of the benchmark; and to change the manager's benchmark to Barclay's Intermediate Government/Credit Index.

Motion Adopted: 6 Yea.

Vote by Roll Call: Mr. James, Yea; Ms. Brewington, Yea;
Mr. Lawson, Yea; Mr. Leahy, Yea;
Mr. Baker, Yea; Ms. Webb, Yea

Discussion was held on the below proposed changes for the OPEB Fund:

1. **Investment Policy Statement:**

   Current: Domestic Fixed Income Investment Guidelines, page 17, *Specific Guidelines, Domestic Fixed Income*, number 2(b) 75%

   New: **40%**

2. **Wilmington Trust Investment Management Agreement:**

   Appendix A,

   Current: Benchmark is Barclay's Intermediate Government Index

   New: Barclay's Intermediate Government/**Credit** Index

A Motion was made by Mr. Baker, seconded by Mr. James, that the Pension Committee recommends to amend the OPEB Investment Policy Statement to change the Domestic Fixed Income guidelines to reflect a minimum of 50 percent of the portfolio must be invested in U. S. Governments, Securities, Treasuries, and Agencies; Corporate Bonds must have a minimum rating of A3/A at the time of purchase; no Corporate Bonds may be purchased below the A3/A rating; the average duration will be no greater than 25 percent of the benchmark and no less than 50 percent of the benchmark; and to change the manager's benchmark to Barclay's Intermediate Government/Credit Index.

Motion Adopted: 6 Yea.

Vote by Roll Call: Mr. James, Yea; Ms. Brewington, Yea;
Mr. Lawson, Yea; Mr. Leahy, Yea;
Mr. Baker, Yea; Ms. Webb, Yea

Mr. Shone referred members to the OPEB Fund Performance Report (Tab III). The OPEB Fund realized investment returns for the fourth quarter of 2012 of $230,000, a return of 1.0 percent (gross) and .9 percent (net), which slightly beat the benchmark (1 percent versus .9 percent). For 2012, the County had a $1.9 million gain (net), or a 8.9 percent return (gross), and 8.4 percent (net). He noted the County's low manager expenses of .37 percent. Mid Cap Value index was added in December and has been the best performer over 10, 20 and 30-year periods. Over time, value stocks have outperformed growth stocks. 2012 saw strong performances by both Dodge & Cox and Ridgeworth. The County lagged behind other same sized plans due to their conservative investment approach – at a time when the stock market was rewarding aggressive investing.

Mr. Shone noted that the following items should be considered by the Committee: Fixed Income Guidelines, Actuarial Return Assumptions, L.D.I., and GASB 67 and 68.

Mr. Shone briefly reviewed a few of the managers' rankings and returns. Black Rock, who is a dividend oriented manager with a conservative style, realized increased last quarter earnings of .4 percent, which ranked slightly below the average. For the year, Black Rock was in the 80th percentile; for the 3 and 5 year periods - 15th and 13th percentile respectively; and they perform better in the down markets. The percentile ranking of '1' denotes the highest performer, with '99' reflecting the lowest. The Vanguard Russell 1000 Index ranked in the 29th percentile for 2012. The Mid-Cap Value Index was up 2.9 for the quarter.

Mr. Shone referred members to a separate handout entitled, "Sussex County OPEB Trust – Total Fund as of January 31, 2013". For the month of January, the OPEB Fund was up 2.9 percent, Black Rock – up 4.4 percent (benchmark - 6.5), Vanguard Mid Cap Index – up 6.7, Ridgeworth Small Cap Value – up 7.7, Dodge & Cox – up 5.4; Harding Loevner – up 4.1. At the current time, small and mid-cap stocks are the best performers, with the County's fixed income composite down .3 percent.

Mr. Leahy inquired if there were any strategic changes/actions the County should be taking as a result of the information contained in the Upside Capture Ratio vs. Downside Capture Ratio chart. Mr. Shone stated that the numbers are reflective of the County's previous limitation in selecting managers. He went on to explain that Peirce Park can review this information – taking into consideration what the County's performance would be given the County's current allocation mix – and report back to the Committee. Discussion ensued regarding the area of real assets. Inflation is of real concern and pension plans are beginning to prepare for this reality. If inflation rises, salaries, benefits and Colas (cost of living adjustments) would increase as well. Indirectly, as inflation goes up, so would the premium needed for fixed income. Governments are starting to look at whether portfolios should include inflation protecting investments (called real assets). Mr. Shone would like to bring an education piece to the Committee regarding real assets (commodities, real estate, and TIPS – Treasury Inflation-Protected Securities), which would assist in the decision-making process.

Mr. James reiterated the point that the Committee may want to consider lessening the County's investment with the State, currently at 60 percent.

Mr. Shone noted that international targets may be another area the Committee would want to consider; the County is 12 percent invested in internationals. Most of Peirce Park's clients, which are at 60 percent equities, have 14 to 16 percent in internationals, and all are considering increasing this amount. Over time, internationals have had more volatility than the U. S. Market. Mr. Shone stated that he will bring some ideas and recommendations to the Committee. Mr. Leahy suggested a profile of similar municipalities and any trends seen.

Ms. Webb thanked Mr. Shone for his presentation.

3. **Aon – Actuary Assumptions/Rate of Return**

Ms. Webb introduced Mr. Lessl. Mr. Lessl asked for questions from the Committee.

The Committee noted the question of whether the County's 8 percent assumed rate of return remains a realistic number. Mr. Baker inquired if there were any regulatory issues that would impact the County's contributions to the fund. Mr. Lessl stated that he felt the County was in good shape in regard to GASB 67 and 68, and the regulations would not have a great impact on the County, primarily because the County is already actuarially funding its plan. He mentioned that when Aon provides the County with its required contribution, which recognizes all of the County's liability, the County has been more than meeting that obligation. Mr. Lessl reported there would be significant impact to those governmental entities whose pension plans that have not been soundly funded.

Mr. Leahy inquired as to how the actuarial accrued liability and minimum required contribution are determined. Mr. Lessl stated that different entities measure different kinds of liability. The County's pension plan uses what is known as a 'projected unit credit method' for determining liability. With this method, Aon projects the expected benefit payouts based on projected salary growth and lengths of service, which is discounted at an assumed rate (8 percent); it is then allocated to time periods over the active employee's working career. This is known as the actuarial accrued liability and is used to compare actual assets contained within the County's trust. There are two components of the County's required contribution: the current year's contribution and the contribution needed to make up for any shortfall. If there is underfunding, that amount is amortized and added to the current year's contribution requirement. Mr. Lessl noted there is great variation in amortization methods used by government entities. The County uses what is known as "level percentage open", a process that involves amortizing the

entire unfunded amount over a 30 year period, and using the same 3-1/2 percent payroll growth assumption. Mr. Lessl reiterated that the County's history has been to contribute more than the required minimum. With the County currently having fewer employees, Mr. Lessl acknowledged this would help offset any liability.

Ms. Jennings stated that she had performed an analysis for the past 5 years and the County had a reduction in payroll costs of 4.9 percent compared to 4 years ago. She noted that the actuary's 3.5 percent assumed rate of payroll growth may need to be reviewed. Two years ago, the County realized the highest increase in payroll of 2.4 percent, and a 1.8 percent increase for the current year. Ms. Jennings stated that the actuarial accrued liability increased $7 million from last year to the current year and inquired as to the basis for such. Mr. Lessl explained that the full actuarial report includes discussion and identifies the components. Aon adopted a new mortality table last year that projects future improvements in mortality; this was one of the driving components for the increase. Aon's mortality tables come from recommendations from the Society of Actuaries. Ms. Webb noted that the actuary's 2013 report will include numbers and recommendations using all scenarios, including differing assumed rates of return. This information will assist the Committee and the County in deciding whether the current 8 percent assumed rate of return needs to be revised. Mr. Baker also noted the benefit of not only looking at the investment returns, but also looking at the assumed rate of payroll growth and the 3.5 percent used by the actuary.

Mr. Lessl explained that he had three areas to address: investment return assumption; review of actuarial assumptions (including the 3.5 percent); and the cost study reflecting the impact of lifting the 25 and 30 year caps on length of service. In explanation, Ms. Webb explained that the Committee had been asked to look at the impact of lifting these caps (medics and dispatchers – 25 years; remaining County employees – 30 years), which were instituted in 2001. Mr. Lessl referred members to a one-page handout showing the impact of lessening the required contribution for another of Aon's clients. For the County, he noted that Aon would look at the required contribution, the actuarial accrued liability, and the vested accrued benefits at the various assumed rates of return (currently 8 percent). He noted the impact to the County would be less due to its history of higher funding levels. Mr. Lessl reported that Florida passed a law in 2012 requiring their state's pension plans to disclose vested liability at 7.75 percent. Aon will prepare an actuarial evaluation as of January 1, 2013 regarding various rates of assumption, as well as the impact of removing the employment cap. In considering a lifting of the length of service cap, Mr. Lessl noted that there would be an offsetting cost due to the fact that while employees would

receive an increase in service credit, a decrease would be realized because it would be assumed employees would work longer, thereby reducing the number of years they would collect a pension.

Mr. Baker requested Aon also review and report on the impact of changing the multiplier used in the pension calculation. Mr. Lessl stated that Aon takes into consideration all the variables (and formulas) for each employee to project their individual benefit.

Ms. Webb questioned both Mr. Lessl and Mr. Shone as to the options available to strengthen a defined benefit plan and to make the plan less expensive. Items discussed include:

Mr. Lessel

- No change for existing employees, but new tier for new hires
- Remove length of service caps, or raise the minimum required retirement age; changes to the length of service caps do not result in big cost savings, but a delay in retirement realizes significant savings
- Delay Cola increases – these increases would not begin immediately upon retirement, a delay of 3 to 5 years
- Employee contributions – most governmental plans have employee contributions
- Mr. Lessl raised the issue as to the legal protection offered to employees who were hired under certain plan provisions and the right they have to stay within those benefit provisions. His experience has been that a delay in Cola increases has been more successful than with a change that would be seen as taking something away.
- Employee contributions – a lot of plans have raised employee contributions, but many of these cases are working their way thru the courts. Mr. Lessl noted that instituting employee contributions does not seem to be as difficult a change as does lowering the multiplier. He has seen contribution changes both for new hires and existing employees.

Mr. Shone

- Pennsylvania's state constitution protects employee benefits; there have been court cases to rule as to the legality of changing employee benefits for current employees, i.e. when they are asked to contribute additional money, etc. In Pennsylvania, pensioner Cola increases are not automatically granted, but are considered annually; many municipalities are not granting these increases to

pensioners. Ms. Webb stated that not granting Cola increases is counterproductive, if budgets will allow them. Mr. Shone has seen some interest in lowering the benefit formula, with the inclusion of a defined contribution plan, or a cash balance plans – which is a combination of the two. With a defined contribution plan, individuals typically do not realize as high a return as does the government entity. If wanted, employees can allow their employer to do the investing with defined plans. Mr. James expressed concern that the employee match could be nonexistent for lower County wage earners.

Mr. Leahy noted that from a private sector and taxpayer perspective, County benefits look very generous. Ms. Webb noted the differing salary structure of the private sector. It was noted that Kent and New Castle County employees all contribute toward their pension plan – both existing and new hires – but at differing rates. To realize true cost savings, contributions by both existing and new hires would need to be implemented.

Regarding the topic of actuarial assumptions, Mr. Lessl reported that Ms. Webb was given a proposal to look at the assumptions, i.e. retirement rates, termination rates, 3-1/2 percent payroll growth scale, salary increases, and also marital assumptions. With some plans that have marital benefits, the employee has the choice of electing spousal protection, but it reduces the participant's retirement benefit. The County has what is known as a subsidized death benefit, which allows the surviving spouse to receive 50 percent of the County employee's pension without reducing the participant's benefit. Best practice is to do an experience study every five years, which includes a process of looking at the actual data (the experience) and comparing it to the assumptions, i.e. what has been projected to occur (retirements at each age, etc.). He noted that past performance is no guarantee as to what will happen in the future. Aon's benefit assumptions are projected long-term (twenty to thirty years in the future).

Mr. Leahy inquired as to issues and opinions of external regulatory bodies i.e. bond rating agencies, County auditors, etc., that should be of concern to the County due to the fact that these agencies speak to the adequacy of the pension reserves, etc. Ms. Webb responded that bond ratings are a complete package and when these agencies look at a financial statement, the pension and how well it is funded is definitely considered for their calculation and rating; the CAFR includes multiple pages of detailed information regarding pension disclosures. Mr. Lessl stated that Moody's will adjust the numbers reported in an actuarial report to current market rates. Even if a

governmental entity uses an 8 percent assumption, Moody's will adjust those numbers to current corporate bond rates and determine the unfunded portion for rating purposes.

Ms. Webb thanked Mr. Lessl for his time and presentation.

4. **Goals for 2013**

As discussed, goals to be considered during 2013 include a change in the Investment Policy for the Pension and OPEB Plans, as well as consideration of the fixed income guidelines, actuarial assumptions, L.D.I. (liability driven investing), and GASB 67 and 68. If Committee members have additional goals, they can be emailed to Ms. Webb.

5. **Additional Business**

Ms. Webb reminded members of the three additional meeting dates in 2013 (Thursday, May 16; Thursday, August 15; and Wednesday, November 13; all beginning at 10:00 a.m.). Due to her upcoming retirement, Ms. Webb noted this would be her last Pension Committee meeting. Mr. Baker praised Ms. Webb for her 20-year service with the County.

Ms. Webb thanked everyone for their attendance.

The meeting was adjourned at 1:18 p.m.

Respectfully submitted,

Nancy J. Cordrey
Administrative Secretary